



**DEPARTMENT OF THE NAVY**  
ENGINEERING FIELD ACTIVITY CHESAPEAKE  
LITIGATION HEADQUARTERS  
WASHINGTON NAVY YARD  
1013 O STREET SE SUITE 340  
WASHINGTON DC 20374-5051

IN REPLY REFER TO:

November 7, 2002

Mr. Gary E. Walsh  
Executive Director  
Public Service Commission of SC  
Columbia, SC 29211

Re: South Carolina Electric & Gas Company  
DOCKET NO. 2002-223-E

Dear Mr. Walsh:

Enclosed please find the original and 25 copies of the prefiled testimony of Donald B. Coates filed on behalf of the Department of the Navy.

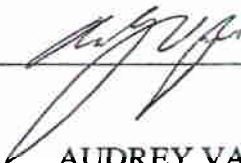
  
AUDREY VAN DYKE  
For the Secretary of the Navy  
(202) 685-1931  
fax (202) 433-2591

cc:  
(by federal express)  
Service List

CERTIFICATE OF SERVICE

I certify that on this date I caused to be served by Federal Express Overnight Delivery a true and correct copy of the Department of the Navy's proposed testimony of Donald B. Coates to the Service List in this proceeding:

This the 7th day of November, 2002.



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AUDREY VAN DYKE  
For the Secretary of the Navy  
(202) 685-1931  
fax (202) 433-2591

**BEFORE THE  
SOUTH CAROLINA  
PUBLIC SERVICE COMMISSION**

DOCKET NO. 2002-223-E  
Application of South  
Carolina Electric &  
Gas Company for  
adjustments in the  
Company's Electric  
Rates and Charges.

Filed August 6, 2002

Direct Testimony of  
Donald B. Coates  
Concerning  
Revenue Requirements

On behalf of

The United States Department of the Navy  
Representing the Consumer Interests of the  
Department of Defense

November 8, 2002

1 Q. Please state your name and business address.

2 A. Donald B. Coates, 1314 Harwood Street SE, Washington Navy Yard, DC 20374-5018.

3 Q. What is your occupation?

4 A. I am a public utility specialist (revenue requirements) with the Navy Rate Intervention  
5 office of the United States Department of the Navy.

6 Q. On whose behalf are you appearing?

7 A. The United States Department of the Navy representing the consumer's interest of the  
8 Department of Defense.

9 Q. Please describe your educational background, qualifications and experience.

10 A. Appendix A to my testimony provides the details concerning my experience and  
11 qualifications.

12 Q. Have you ever presented testimony before this Commission or any other regulatory  
13 body?

14 A. Not before the South Carolina Public Service Commission, however I have testified  
15 before the Oklahoma Corporation Commission and the Delaware Public Service  
16 Commission as a member of Commission staff in both States.

17 Q. Please describe the tasks you performed related to your testimony in this case.

18 A. I reviewed the filings made by the South Carolina Electric & Gas Company (SCE&G) in  
19 this docket and performed other procedures as necessary to gain an understanding of its  
20 proposals and to formulate an opinion concerning the reasonableness of such proposals in  
21 the area I am covering.

22 Q. What issues will you be addressing in your testimony?

23 A. My direct testimony discusses selected issues related to revenue requirements.

1 Q. Please proceed.

2 A. I am proposing that the Civil Penalty levied by the South Carolina Department of Health  
3 and Environmental Control in the amount of \$101,000 be removed from Account No.

4 921 because civil penalties should not be charged to ratepayers.

5 Q. Is there another adjustment you would like to propose?

6 A. Yes. As the Commission found in the previous case, I propose that M&S Inventories  
7 (Except Nuclear) included in Rate Base be valued by using a test year average instead of  
8 year end balances. Adjusting "Materials and Supplies –Electric" as itemized on SCE&G  
9 application Exhibit D-IV to reflect average instead of year-end balances will reduce Rate  
10 Base by \$10,730,422 as shown on my exhibit DBC-1.

11 Q. Have you reviewed SCE&G's proposed Proforma Adjustment number 9 on SCE&G  
12 Exhibit D-II page 3 of 3?

13 A. Yes, I have reviewed this adjustment. It increases FERC account 926 Employee  
14 Pensions and Benefits expense from \$6,025,000 test year, per books to \$17,095,000 test  
15 year, pro forma. There are two parts to this adjustment, as itemized in Answer No. 65 to  
16 PSC Data Request No. 1. Adjustment #9A proposes to recognize a 67.2% decrease in  
17 Pension Trust Fund Income of \$10,942,703 and adjustment No. 9B proposes to recognize  
18 a 1.66% increase in Other Post Employment Benefits of \$153,908 with a corresponding  
19 0.15% increase to the unfunded liability in Rate Base of \$95,038.

20 Q. Do you agree with SCE&G's proposed adjustment number 9?

21 A. Adjustment No. 9B appears reasonable, however, I do not agree with adjustment No. 9A  
22 related to Pensions.

23 Q. Please explain.

1 A. The proposed adjustment is based on using recent data as the basis for adjusting test year  
2 amounts. However, SCE&G does not show proof that recent data is more representative  
3 of a "normal year" than the actual test year. Considering the value of the long-term  
4 investments in the Pension Trust Fund will fluctuate from day to day, SCE&G's use of  
5 recent data is not more representative of a normal year than the actual test year data.  
6 Although, broad measures of investments market values in the United States, such as the  
7 Dow Jones Industrial Average and the Standard & Poor 500 Index, fluctuate from day to  
8 day they have reflected gains in the long term as shown on my Exhibit DBC-2. It appears  
9 that the basis for SCE&G's proposed adjustment is temporary "paper losses" selected at a  
10 low point in market valuations.

11 "The Thrift Savings Plan's C Fund bounced back in October, emerging from a year-long  
12 slump, according to the latest numbers from the plan. The C fund, which invests in  
13 common stocks, saw its biggest boost since November 2001, climbing 8.77 percent in  
14 October. The increase was a significant rally for the fund, which fell 10.87 percent in  
15 September and dropped 15.1 percent the past year."<sup>1</sup>  
16

17 Q. Are you proposing to use Test Year per Books Pension Income of \$16,292,735, and if  
18 you are, how will SCE&G recoup the market losses on pension fund assets?

19 A. Yes. The point is that just because an expense level will change in the future, and there  
20 are mechanisms to measure that change, does not mean the change meets the regulatory  
21 criteria of "known and measurable" changes outside of the test year. In their January 9,  
22 1996 order, the commission included Annual Pension Expense (Income) of (\$2.6) million  
23 in the revenue requirement used to set rates. It was "known and measurable" at that time  
24 that the actual pension income would never be \$2.6 million. History is now available to

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<sup>1</sup> Reference: <http://207.27.3.29/dailyfed/1102/110502t1.htm>. Pension trust fund that tracks S&P 500.

demonstrate this fact. The SEC 10-K reports Net periodic pension (income) expense for SCE&G as:

Year Pension Income (In Millions)

1994 (\$2.9) Expense

1995 \$4.6

Test Year \$2.6

1996 \$9.8

1997 \$16.1

1998 \$32.5

1999 \$27.7

2000 \$41.5

2001 \$41.1

Quite some contrasts, even considering not all of the SEC 10K amounts are jurisdictional, for calendar year 2001 in developing test year amounts SCE&G uses \$17.5 million or 43% of the \$41.1 million reported to the SEC. Pension Fund assets are long-term assets set aside to meet long term needs. In the long run, the current market downturn will be mitigated as illustrated on my Exhibit No. \_\_\_\_ (DBC-2). The Commission should reject the Company's proposed adjustment because the recorded test year amounts already reflect a significant portion of the market downturn in Pension Fund assets and serves as a reasonable proxy for future amounts to establish revenue requirements. (See Exhibit No. \_\_\_\_ (DBC-3)).

Q. Have you reviewed Adjustment number 20 on SCE&G Exhibit D-II page 3 of 3?

1 A. Yes, I have. It recognizes in Rate Base unamortized deferred costs of \$6,575,000 and an  
2 annual expense claim of \$2,630,000 in FERC Account 566 (Misc. Transmission  
3 Expense) to amortize the deferred costs claimed in Rate Base. Adjustment number 20  
4 permits a revenue requirement from retail customers for expenses incurred prior, during  
5 and after the test year and accumulated as deferred expenses for GridSouth Regional  
6 Transmission Organization (RTO) project start up, made by the utility in response to  
7 FERC Order No. 2000. The project was suspended by SCE&G management following  
8 an order issued by FERC July 12, 2001, Carolina Power and Light Co. et al, 96 FERC ¶  
9 61,067 (2001).

10 Q. Do you agree with SCE&G's proposed adjustment number 20?

11 A. No. I propose no change in account 566 expenses or Rate Base for the Test Year to  
12 recognize GridSouth deferred expenses as shown on Exhibit\_(DBC-4).

13 Q. Please explain.

14 A. There are two separate reasons. The first reason is related to allowable deferred expenses  
15 issues and the second reason is related to jurisdictional issues.

16 Q. What are the allowable deferred expense issues?

17 A. The ratemaking treatment of expenses can be described as an "either or" proposition. If  
18 an expense is non-recurring, it should be excluded from expenses and be considered for  
19 recovery through amortization. If an expense is an ordinary operating expense, it should  
20 be considered within the normalized level of expense for current rate recovery. The  
21 GridSouth expenses are clearly non-recurring because SCE&G does not attempt to form  
22 more RTOs on a regular recurring basis. Thus, we are left to examine the standard for  
23 allowing amortization of non-recurring costs. The primary objection is that these costs do



1 not meet the traditional standards for deferred cost recovery. The most common basis is  
2 the extraordinary event standard. In this instance, the expense is the result of an non-  
3 recurring event that has a significant adverse impact on the utility's financial condition.

4 These costs do not rise to such significant level. In fact they do not even rise to a level of  
5 materiality as they are less than 1% of annual sales and less than ¼% of total assets. The  
6 other common basis is the future benefit standard. GridSouth start up costs and expenses  
7 may eventually meet this standard and be included in the FERC transmission tariff and  
8 allocated to the retail jurisdiction, but as of today, any possible future benefit to retail  
9 ratepayers is neither known nor measurable.

10 Q. Please explain the jurisdictional issues.

11 A. As SCE&G explained in its response to Consumer Advocate Interrogatory No. 2-22,  
12 FERC Order 2000 prompted the creation of RTOs and GridSouth utilities were granted  
13 provisional authority for formation of the GridSouth RTO by the FERC on March 14,  
14 2001. Later, when FERC required GridSouth to expand to be regional in scope, SCE&G  
15 management reacted by suspending the GridSouth project. Thus, both the impetus for  
16 expending funds and the suspension of the project did not come from this Commission's  
17 jurisdiction. Yet, the FERC transmission tariffs do not currently include these costs.  
18 Nevertheless, SCE&G is seeking to recover from South Carolina PSC jurisdictional  
19 customers who did not create the circumstances that led to these costs. If the FERC does  
20 approve of these costs and include them in FERC tariffs, it would then be reasonable to  
21 permit allocation of appropriate transmission costs to the retail jurisdiction. In this  
22 instance, no such finding has been made by the FERC. Thus, allowing these costs to be  
23 recovered from retail customers is premature.

1 Q. Have you reviewed Adjustment number 24 on SCE&G Exhibit D-II page 3 of 3 and what  
2 is your understanding of the purpose of this "Working Cash" adjustment?

3 A. Yes, I have reviewed this adjustment, which recognizes the investment required by the  
4 utility to complete the cash conversion cycle using the 45-day method (1/8 or 12.5%)  
5 established as an industry standard by the Federal Power Commission in the 1940's.

6 Q. What is a cash conversion cycle?

7 A. A cash conversion cycle is the number of days from cash outflows to produce and deliver  
8 service until amounts due from the customer for services provided are collected. Thus,  
9 for SCE&G the cash conversion cycle begins with the expenditure of cash to fund  
10 operations and maintenance expenses to produce and deliver electricity and ends with the  
11 collection of cash payments from customers for electric service received.

12 Q. Is 45 days an appropriate cycle and has SCE&G used this method fittingly?

13 A. In the absence of a lead lag study, 45 days is an appropriate measure, commonly accepted  
14 by utility commissions in the United States. However, SCE&G has applied the formula  
15 to some accounts in the O&M expenses that represent double counting. I agree with  
16 SCE&G's exclusion of FERC Accounts 518 and 555, however there are other accounts  
17 that should have been excluded from the calculation. Specifically, the level of O&M  
18 expenses used in this calculation should exclude:

- 19 • FERC Account 501 Fuel because fossil fuel stock is included in Materials &  
20 Supplies Rate Base claim.
- 21 • FERC Account 509 Allowances because SO2 Emission Allowances Inventory is  
22 included in Materials & Supplies Rate Base claim.

- FERC Account 547 Fuel because fossil fuel stock is included in Materials & Supplies Rate Base claim.

- FERC Account 904 Uncollectible Accounts because this is not a cash expense, but amounts due and not received.

Q. Have you calculated the impact of excluding those accounts from the O&M expenses used in the working cash calculation and do you have a recommendation?

A. Yes. Test Year Total, as Adjusted O&M Expenses used in the calculation would be reduced by \$303,743,000 to \$366,372,000. Working Cash, as Adjusted would be reduced by \$26,254,000 to \$45,797,000. I recommend that the Commission include in rate base working cash of \$45,797,000 before allocation to retail and adjusted for any changes to O&M expenses the Commission adopts using 1/8 of O&M expenses as calculated on my Exhibit No. \_\_\_\_ (DBC-5).

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1 Q. Please summarize your recommendations.

2 A. My recommendations are summarized as follows:

3 1. The Commission should remove the \$101,000 Civil Penalty from account No.

4 921 as a non-allowable expense.

5 2. The Commission should reduce Rate Base by \$10,730,422 to recognize test

6 year average inventory balances instead of test year end, as more reflective of

7 SCE&G's normal, ongoing inventory levels.

8 3. The Commission should not accept SCE&G's proposal to adjust Test Year

9 Pension Income level because its proposal is no better predictor of future

10 Pension (Income) Expense than what was actually recorded during the test

11 year.

12 4. The Commission should reject SCE&G's proposal to have South Carolina

13 jurisdictional customers pay for costs and expenses generated because of

14 FERC actions, but not included in FERC tariffs.

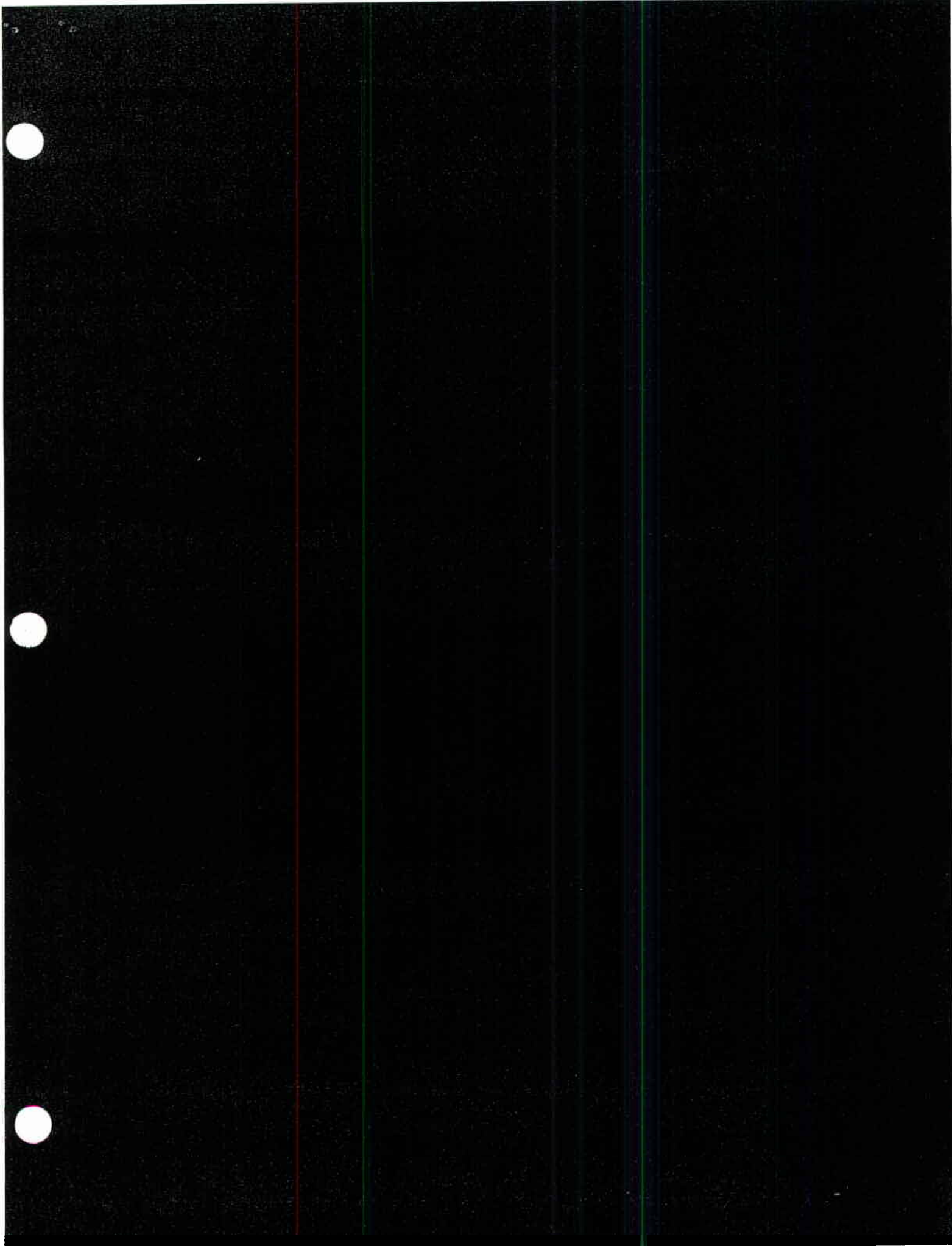
15 5. The Commission should exclude accounts 501, 509, 547 and 904 from

16 expense levels used in the working cash calculation.

17

18 Q. Does this conclude your direct testimony?

19 A. Yes, it does.



**Donald B. Coates**

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**Experience** 4/98 to Present US Navy, Facilities Engineering Command

**Public Utilities Specialist**

- Provided technical analyses for utility rate filings and rule makings.
- Technical Issue Administration of professional services contracts for consultants
- Project coordination for utility rate case intervention and utility rate contract negotiations
- Jurisdictions included: Arizona, California, Connecticut, Florida, Louisiana, Maine, Maryland, Mississippi, North Carolina, New Jersey, Nevada, Pennsylvania, Rhode Island, South Carolina and Virginia

7/97– 4/98 Snavely, King, Majoros, O'Connor & Lee, Inc. Washington, DC

**Senior Consultant – Regulated Industries**

Prepared various studies for use in regulatory proceedings for telecommunications carriers, water and energy utilities and railroads. Prepared studies used for business plans and litigation in cellular telephone, hospitality and franchising industries.

1/96 - 7/97 US Navy, Facilities Engineering Command Washington, DC

**Public Utilities Specialist**

- Provided technical analyses for utility rate filings and rule makings.
- Technical Issue Administration of professional services contracts for consultants
- Project coordination for utility rate case intervention and utility rate contract negotiations

4/90–8/95 Delaware Public Service Commission Dover, DE

**Chief, Accounting & Finance (Interim Executive Director 5/95-8/95)**

- Senior technical advisor to the Commissioners
- Directed technical staff and managed consulting resources
- Represented commission staff in public meetings, hearings Commission Deliberations
- Collaborated with commission counsel in developing case strategies

2/85–3/90 Oklahoma Corporation Commission Oklahoma City, OK

**CPA/Auditor**

- Conducted rate case examinations and other utility regulation investigations, serving at times as auditor in charge and primary staff witness

1/81-12/84 Delco Construction, Inc. Oklahoma City, OK

**Controller**

- Responsible for all accounting and record keeping systems (including IS hardware and software), financial reporting, cash management and compliance with tax and regulatory requirements.

**Donald B. Coates**

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- Education**
- 1974 Central State University Edmond, OK 73034
- B.Sc., Accounting
  - Continuing Professional Education Annually for CPA requirements
  - State of Oklahoma Certified Public Accountant, Certificate No. 3327
- 2001 – 2002 American University Washington, DC 20016
- Kogod School of Business 10.5 Sem. Hrs complete, 6 Sem. Hrs current enrollments in MBA program, projected completion 2005.
- Presentations & Publications**
- The following presentations are related to accounting and/or utility regulation
- Continuing education discussion leader for Oklahoma Society of Certified Public Accountants
    - “Effective Accounting and Auditing Research”, August 25, 1986 and
    - “Audit Materiality and Risk”, May 21, 1987
  - Presented “Report on Deferred Accounting for Ratemaking” at NARUC Staff Committee on Accounts Fall 1993 meeting, published in NRRI Quarterly Bulletin.
  - Presenter at the September 1994 NRRI/NARUC Biennial Regulatory Information Conference. Title of paper is “Air, Moonlight, Sunlight, Water and Other Free Things-(Like Lunch)”. Published by NRRI
  - Panelist for “Electric Industry Restructuring Discussion” NARUC Staff Committee on Accounts, Fall 1996 meeting. (Title of paper is “Pending Federal Legislation” and focused on the Schaefer bill from the 104<sup>th</sup> Congress.)
  - The Power Marketers Association, Implementing Retail Wheeling Conference '98, June 4, 1998, presented a paper titled “Rate Design In A Competitive Environment”. Published May 1998 in PMA On Line Magazine at <http://www.powermarketers.com> and at <http://www.snavely-king.com/links.htm>

**Donald B. Coates**

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<b>Witness Appearances</b>	<b><u>Year</u></b>	<b><u>Utility</u></b>
<b>Oklahoma Corporation Commission</b>	1985	Wheeler Gas Company
	1985	Choctaw Water Company
	1986	Summit Water Company
	1985	Tenkiller Water Company
	1986	Cimarron Electric Cooperative ( <i>Copy Available</i> )
	1987	Cookson Hills Electric Cooperative ( <i>Copy Available</i> )
	1988	Caddo Electric Cooperative ( <i>Portion Available</i> )
	1989	Felt Water Development Company (Gas Utility serving irrigation wells) ( <i>Copy Available</i> )
	1989	River Oaks Water Company
<b>Delaware Public Service Commission</b>	1990	Delaware Electric Cooperative
	1991	Public Water & Supply Company
	1992	Delaware Electric Cooperative ( <i>Copy Available</i> )

As Chief of Technical Staff during Commission Deliberations, I appeared in over 200 dockets before the Delaware Public Service Commission. In this role I would answer technical inquiries, and offer analysis and explanations of the consequences of various choices facing the commissioners, including positions taken by applicants and intervenors.



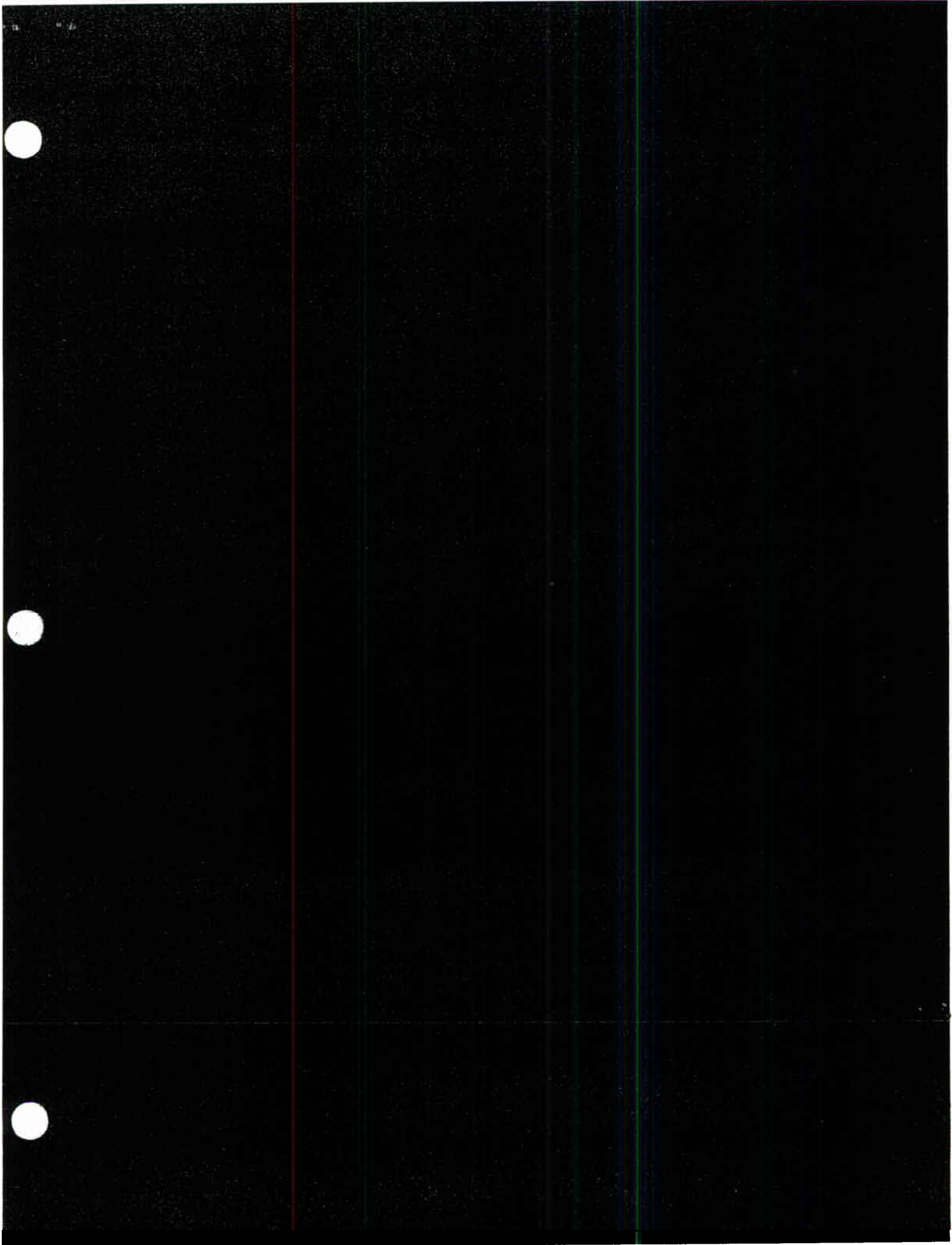
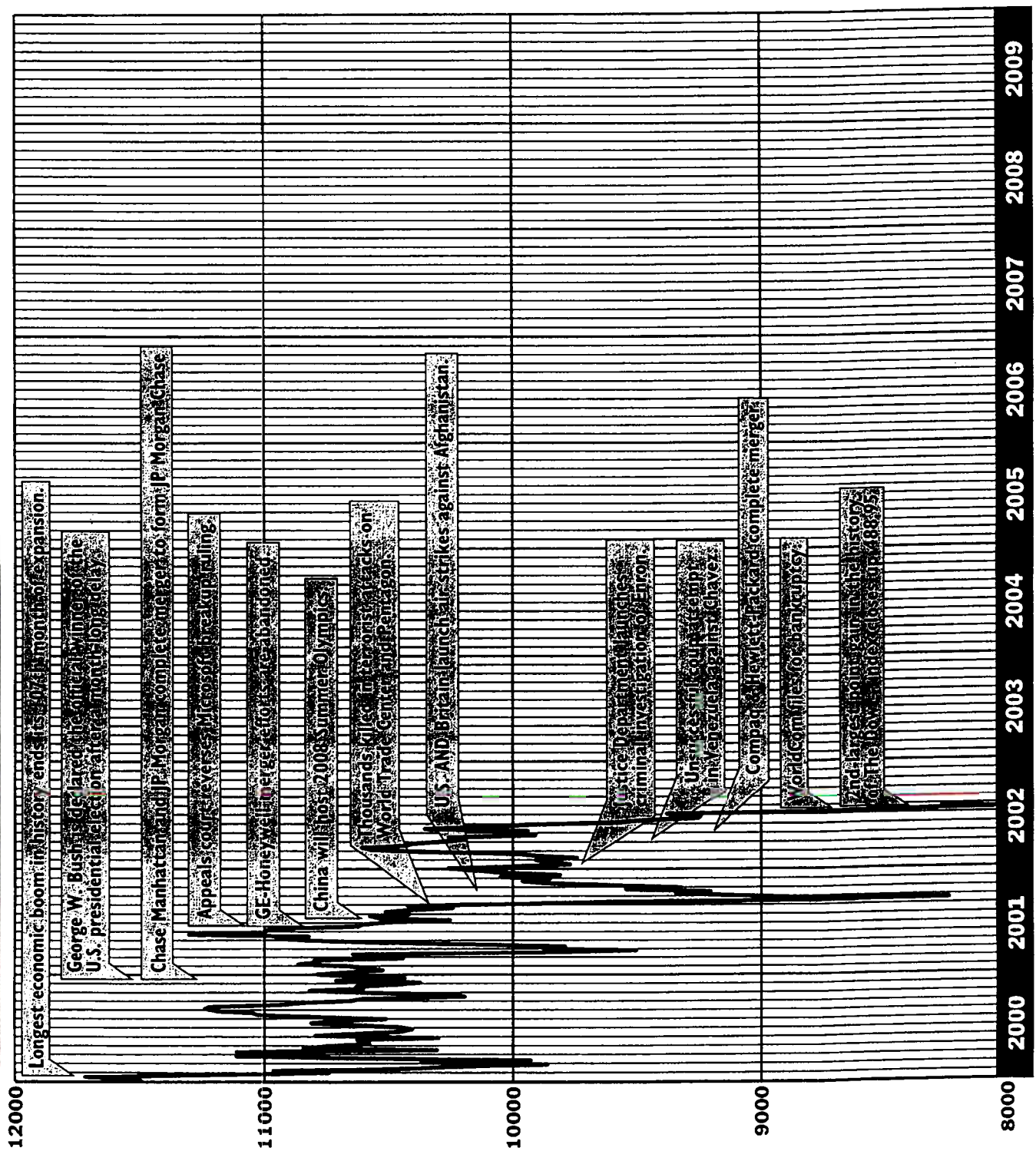


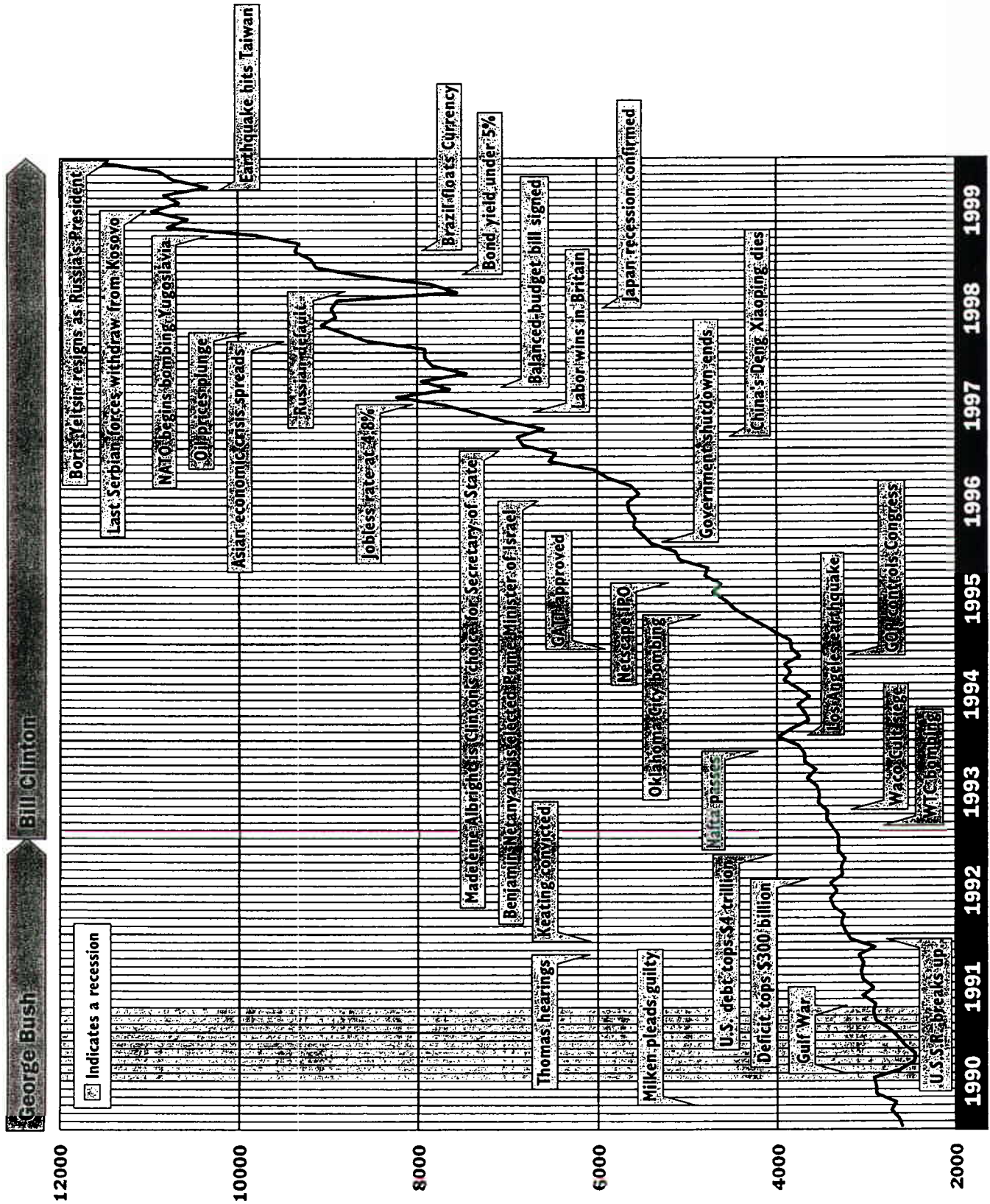
EXHIBIT No. \_\_\_\_ (DBC-1)

SOUTH CAROLINA ELECTRIC & GAS COMPANY  
Electric Pro Forma Adjustment to Adjust Rate base to Average Inventories  
DOCKET NO. 2002-223-E  
TEST YEAR ENDED MARCH 2002

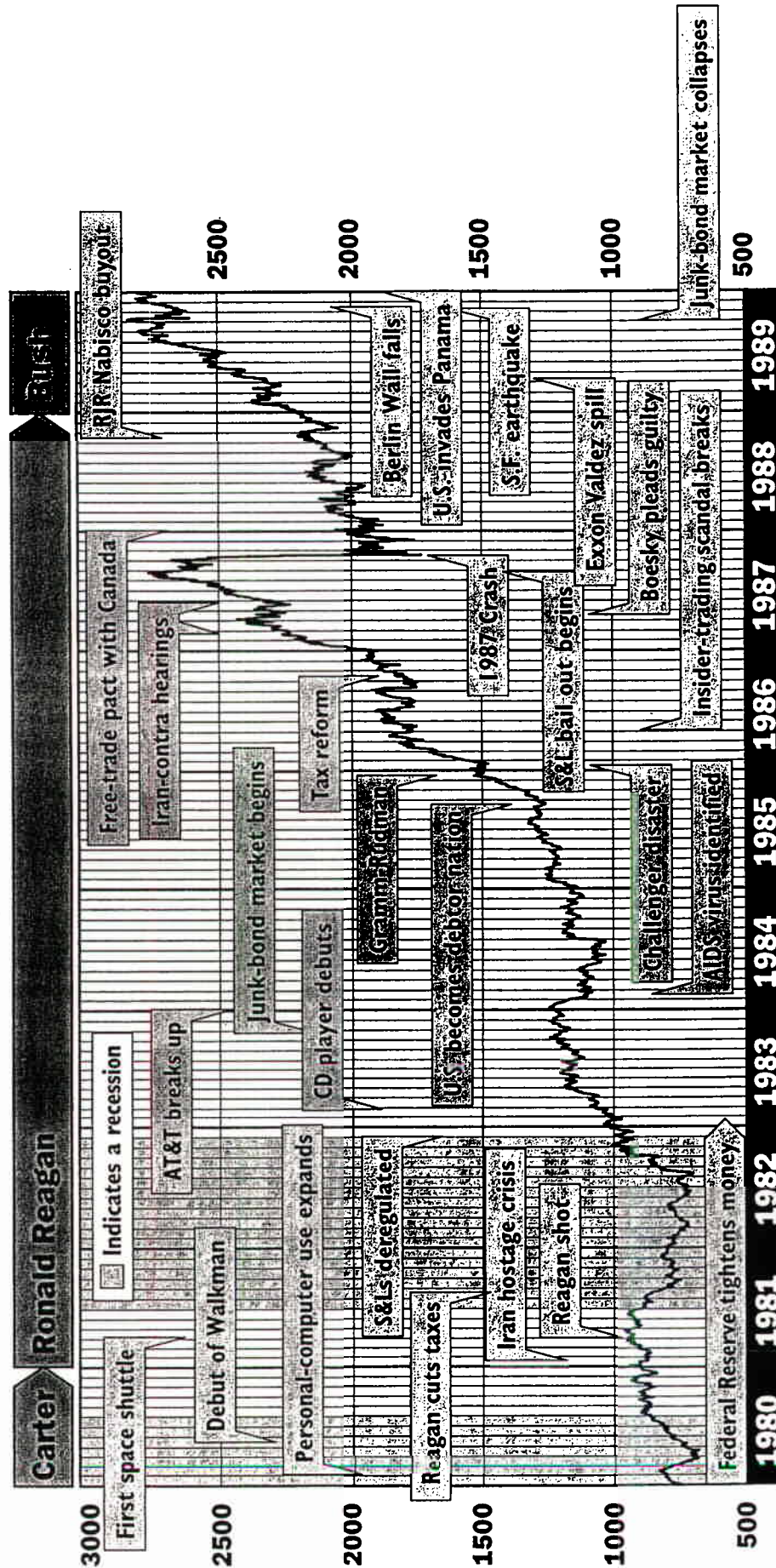
Data Source: South Carolina Audit Request No. 22 SCE&G Response  
Line

No.	Description	Details	Per Books	Details	Average	Details	Proforma Adjustment
1	Coal	\$39,764,249		\$29,776,228		\$(9,988,021)	
2	Other	2,797,365		2,535,464		(261,901)	
3	Fossil Fuel		42,561,614		32,311,692		(10,249,922)
4	General M&S	36,459,580		35,237,130		(1,222,450)	
5	Common	12,546,716		11,994,475		(552,241)	
6	Electric M&S		49,006,296		47,231,605		(1,774,691)
7	Air Emissions		14,441,697		15,735,888		1,294,191
8	Sub Total Inventories		\$ 106,009,607		\$ 95,279,185		\$ (10,730,422)
9	Nuclear Fuel		50,714,000		50,714,000		-
10	Total M&S Inventories		\$ 156,723,607		\$ 145,993,185		\$ (10,730,422)

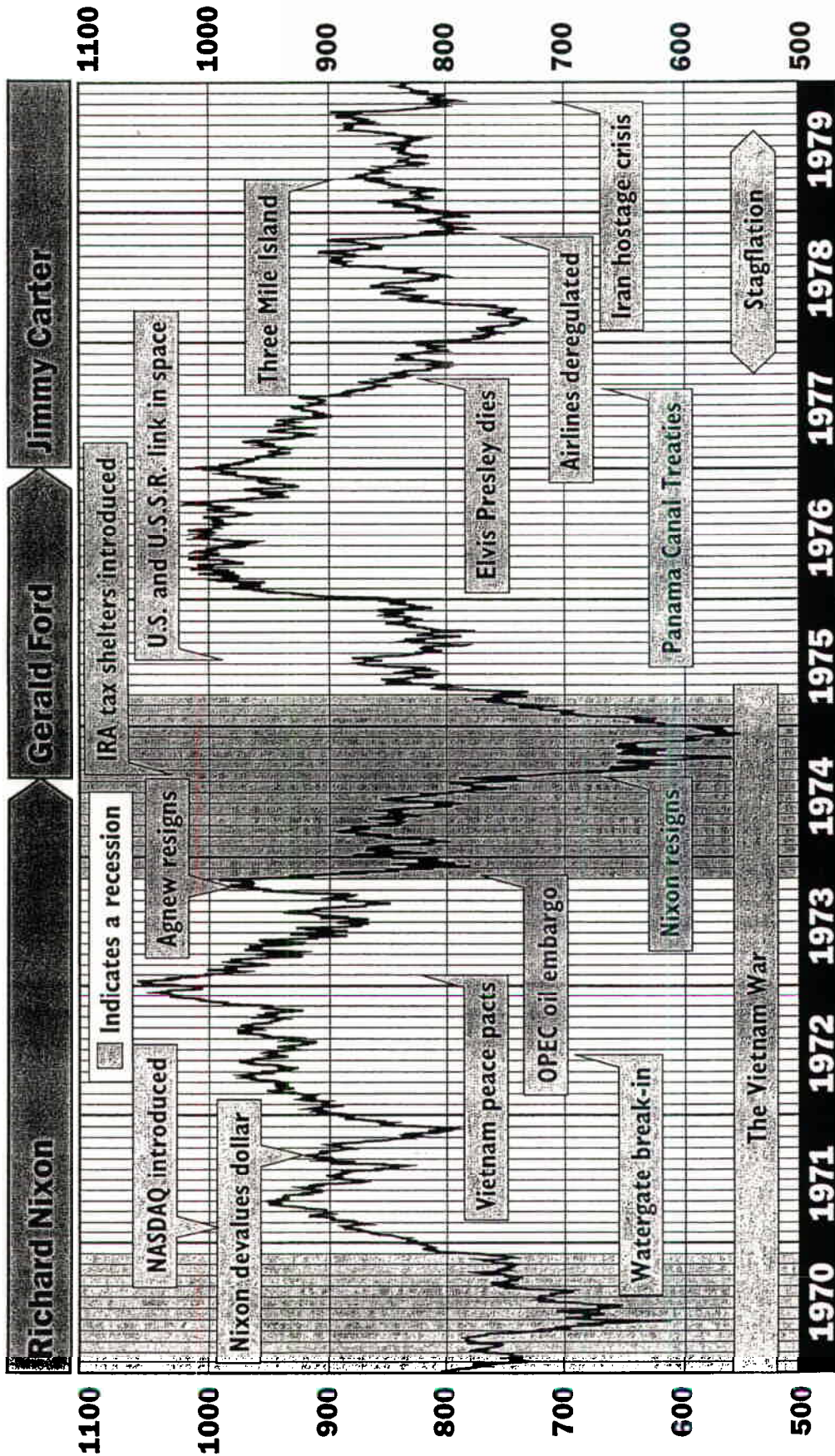








DOW JONES



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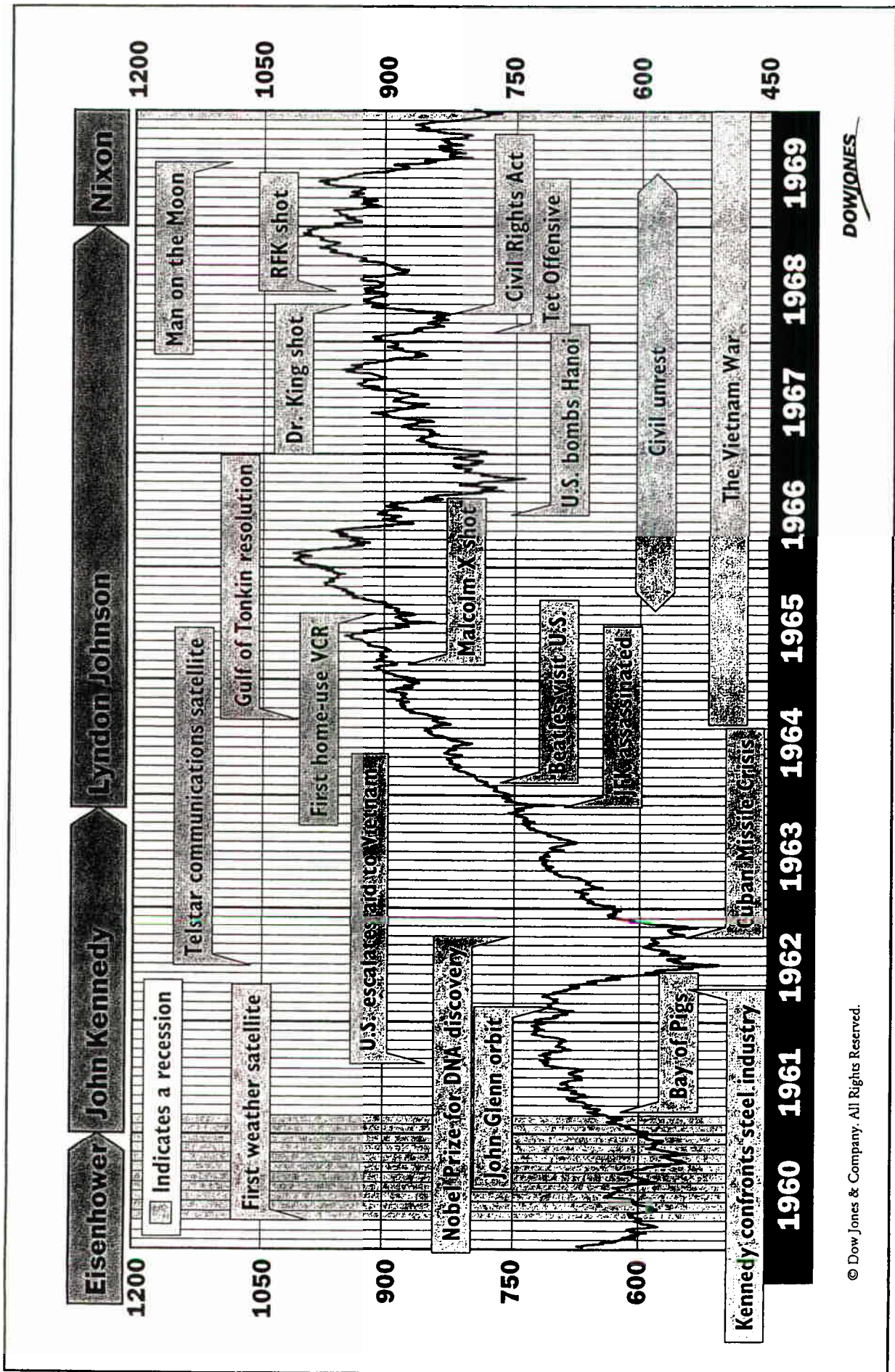


EXHIBIT No. \_\_\_\_ (DBC-3)

SOUTH CAROLINA ELECTRIC & GAS COMPANY  
Electric Pro Forma Adjustment No. 9A - Employee Benefits - Pensions  
DOCKET NO. 2002-223-E  
TEST YEAR ENDED MARCH 2002

<u>Line No.</u>	<u>Description</u>	<u>Per SCE&amp;G</u>	<u>Per Navy</u>
	(Col. 1)	(Col. 2)	(Col. 3)
1	Test Year Pension Income in Account 926	\$ (16,292,735)	\$ (16,292,735)
2	Decrease in Pension (Income)	10,942,703	-
3	Pro forma Pension Income	<u>\$ (5,350,032)</u>	<u>\$ (16,292,735)</u>



EXHIBIT No. \_\_\_\_\_ (DBC-4)

SOUTH CAROLINA ELECTRIC & GAS COMPANY  
 Electric Pro Forma Adjustment No. 20 - GridSouth Deferred Expenses  
 DOCKET NO. 2002-223-E  
 TEST YEAR ENDED MARCH 2002

<u>Line No.</u>	<u>Description</u> (Col. 1)	<u>Per SCE&amp;G</u> (Col. 2)	<u>Per Navy</u> (Col. 7)
1	Account 566 Test Year	1,273,000	1,273,000
2	Increase in FERC Account 566 Expenses	\$ 2,630,000	\$ -
3	Account 566 Pro forma	<u>\$ 3,903,000</u>	<u>\$ 1,273,000</u>
4	Rate Base Claim	<u>\$ 6,575,000</u>	<u>\$ -</u>

EXHIBIT No. (DBC-5)

SOUTH CAROLINA ELECTRIC & GAS COMPANY  
Electric Pro Forma Adjustment No. 24 - Working Cash  
DOCKET NO. 2002-223-E  
TEST YEAR ENDED MARCH 2002

All Amounts in Thousands (\$000)										Per Navy Increase (Decrease) in Rate Base
Line No.	Description	(Col. 1)	Per SCE&G (Col. 2)	Per SCE&G (Col. 3)	Per SCE&G (Col. 4)	Per Navy (Col. 5)	Per Navy (Col. 6)	Per Navy (Col. 7)		(Col. 8)
1	O&M Expenses			\$ 697,279						
2	Less:									
3	FERC Account 501 Fuel	\$ -								
4	FERC Account 509 Allowances		0							
5	FERC Account 518 Fuel		25,252							
6	FERC Account 547 Fuel		0							
7	FERC Account 555 Purchased Power		131,273							
8	FERC Account 904		0							
9	Total O&M to exclude from working cash			156,525						
10	O&M to use for working cash			\$ 540,754						
11	Working Cash Factor for 45 Days			1/8		\$ 67,594				
12	Working Cash Per Books									
									Per SCE&G	
									\$ 67,594	
13	O&M Expenses			\$ 670,115			670,115			
14	Less:									
15	FERC Account 501 Fuel		-			\$ 196,367				
16	FERC Account 509 Allowances		-			7,831				
17	FERC Account 518 Fuel		25,252			25,252				
18	FERC Account 547 Fuel		-			3,970				
19	FERC Account 555 Purchased Power		68,459			68,459				
20	FERC Account 904		-			1,864				
21	Total O&M to exclude from working cash			93,711			303,743			
22	O&M to use for working cash			\$ 576,404			\$ 366,372			
23	Working Cash Factor for 45 Days			1/8			1/8			
24	Working Cash Per Books				\$ 72,051			\$ 45,797		(26,254)
25	Increase (Decrease) to Working Cash				\$ 4,456			\$ (21,798)		(26,254)

Note: These calculations need to be adjusted to conform with Commission findings for allowable O&M Expenses.